ECONOMIC GROWTH INITIATIVE IN LEBANON

March 1998

Prepared for:

USAID/LEBANON

Prepared by:

SRI International

ECONOMIC GROWTH INITIATIVE IN LEBANON

Table of Contents

Page

ECONOMIC GROWTH INITIATIVE IN LEBANON

I. EXECUTIVE SUMMARY

This report presents the findings of the first phase of an economic initiative sponsored by the U.S. Agency for International Development (USAID). The first phase consisted of a diagnostic assessment of Lebanon's economic conditions, constraints and opportunities, aimed primarily at identifying needs to be addressed during the second phase of the initiative. A key emphasis of the inquiry was placed on Lebanon's economic and commercial policies. The purposes of this report are to assess the nation's overall economic performance and policy framework, identify policy strengths and weaknesses, and articulate a medium-term initiative aimed at stimulating productive economic activities in Lebanon.

Domestic Economic Performance

Lebanon's economic performance, prospects and policy strategies can only be understood in the context of the protracted, debilitating war the nation experienced and from which it is now emerging. Accordingly, the nation's recent experience can best be described in terms of three time periods: The pre-war era, the war years, and the post-war period of recovery.

Despite occasional disturbances, the pre-war economy achieved solid economic growth and rising incomes over the period between 1950 and 1975. Economic growth was robust, averaging 6 percent in real terms. In the mid-1970s, Lebanon was considered a middle-income country. Per capita income was estimated in 1974, approaching that of Portugal and about three times the levels prevailing in Egypt or Jordan. Lebanon was the thriving regional finance and trade center, and was a major tourist destination. It was the only significant model for market oriented, private sector-led growth in the region.

The impact of the 15-year war in Lebanon was devastating. Much of the nation's infrastructure was virtually destroyed. Many of the country's residents fled to other nations. Those that remained were forced to concentrate on personal security and economic survival. The ultimate impact was a continuous downward spiral of economic activities.

The recovery years of the 1990s have witnessed great strides in reconstruction, a return to social and economic order, and the re-emergence of productive ventures. A significant share of growth has been directly associated with reconstruction, however, insufficient attention has been placed on "export oriented" activities. As a result, the initial construction-driven boom has reached a plateau, and concerns over macroeconomic stability have given rise to a widespread sense of caution and even pessimism.

International Economic Performance

Lebanon historically has been a service economy, importing more goods than it exports, and covering its trade deficit with surpluses in its services and capital accounts. The country has run overall balance of payments deficits only twice in the past twenty years. But now under the pressure of heavy expenditures for reconstruction and the general rebuilding of the economy, the merchandise trade deficit has grown to tremendous proportions for a small economy like Lebanon.

Lebanon depends heavily in inflows of capital and remittances. In recent years, capital inflows have been directed to investments in real estate and in portfolio instruments. The latter have been encouraged by high real interest rates created by the government's tight monetary policy. The growing concern is whether capital can continue to be attracted in view of the rapidly rising indebtedness of the government, which has financed chronic and growing fiscal deficits with the issuance of government securities.

The Macroeconomic Policy Framework

Lebanon's senior economic management team is sophisticated by both regional and international standards, and strongly supports appropriate policy principles. Policy makers embrace the desirability of private sector-led growth, and voice a common view against government intervention in the economy. These leaders are supported by a widespread national consensus in favor of market forces and private enterprise. Notwithstanding disagreements in other areas, the degree of unanimity on long-term economic policy is unique, and represents a strength upon which Lebanon can build an effective, unifying strategy.

The nation's fundamental dilemma regarding macroeconomic policy stems from the need to rebuild the economy and at the same time maintain socio-political stability, which implies high government expenditures, despite the fact that Lebanon's productive sectors are not yet ready to finance the fiscal burden through tax revenues. This in turn gives rise to concerns over the pace of reconstruction and the levels of government-provided employment and services. Once again it was the war that has created this dilemma.

There is a growing consensus in Lebanon that continued large government deficits are unsustainable. The danger is that if uncorrected, Lebanon's ability to attract increasing amounts of foreign capital inflows may prove inadequate to cover the deficit, leading to a crisis of confidence, capital flight, and a difficult "hard landing" for the economy. Proposed solutions focus on both increasing revenues and reducing expenditures.

The Commercial Policy Framework

The project team began this assessment by examining Lebanon according to the Commercial Policy Model developed by SRI International. This model provides for the "scoring" of commercial policies in nine categories: Import, Export, and Tax Policies, Investment Incentives, Foreign Investment Restrictions, Business Start-Up Procedures, Pricing and Interest Policies, the Foreign Exchange System, and Labor Policies. Once scored with values ranging between 0 and 100, countries can then be compared to regional competitors and international best practices.

Lebanon scores high on its commercial policies, achieving a score of 81 (the highest global score is 92 held by Singapore). Lebanon offers the best commercial policy environment among the regional countries used as benchmarks (Bahrain, Cyprus, Egypt, Jordan, Morocco, and Tunisia). Jordan was the closest competitor with a score of 77. Lebanon performs well in tax, export, import, foreign exchange and labor policies in relation to its regional competitors. The major policy problem to be addressed is the need to improve business start-up procedures.

Unique Factors Affecting Lebanon's Economic Strategy

Any strategy designed to stimulate a nation's productive economic activities should be based on the country's actual conditions, opportunities and constraints. Many patterns of environmental factors and performance can be held in common by a number of countries, and individual conditions can be similar to those experienced in other countries. Nevertheless, each nation is unique and faces a singular blend of economic, social and political factors that collectively determine its economic prospects. Accordingly, each requires its own tailored approach to fit its particular circumstances.

Lebanon is unique, and displays a number of special factors or "drivers" that need to be taken into consideration in the design and implementation of an effective economic strategy. These include both constraints that need to be addressed and opportunities upon which a plan should capitalize.

Constraint Drivers

- **Externally-imposed political risk**
- **The cost of physical reconstruction**
- **The need to modernize "soft" infrastructure**
- **The small size of the market**
- **Lack of consensus on Lebanon's economic future**

Opportunity Drivers

- **The pro-market orientation of the government and people**
- **The heritage of entrepreneurship**
- **The Lebanese "Diaspora" (overseas Lebanese community)**

Economic Growth Balance Sheet

While economic and commercial policies form the critically important environment for productive activities, a nation's economic performance is affected strongly by its various endowments of resource inputs, which collectively determine its comparative advantage. Equally important is the ability of economic actors to enhance their country's resource strengths and overcome resource constraints -- essentially transforming comparative advantage into competitive advantage. One way to gauge an economy's overall strengths and weaknesses is to prepare a "balance sheet assessment." Simply stated, this technique identifies both "assets" and "liabilities" in key input areas, such as natural resources, labor, capital, infrastructure, and so forth.

In broad terms, Lebanon's most important economic asset is its labor force, which is highly educated and motivated. Offsetting this strength, however, is the relatively high cost of labor at all levels, at least in relation to regional competitors. Lebanon has little in the way of natural resources except its moderate agricultural capacity and water supplies, and its regional location.

Lebanon is by regional standards strong in capital resources (both availability of capital and sophistication of the financial markets), but investment is stymied by high interest rates. The nation's technology base is generally an asset, but many industries require significant investments in new technologies in order to enhance their competitiveness. Finally, the infrastructure base remains weak due to war damage, but is recovering rapidly. Overall, Lebanon's economic balance sheet suggests that the nation should concentrate on the production and sale of high value, "niche" goods and services.

Proposed Economic Growth Strategy and Initiative

During the course of the investigation, it became increasingly clear that the substantive scope of subsequent phases of this initiative should be broadened somewhat from a solely policy-oriented focus to cover other issues affecting productive economic activities. This conclusion is based on the following considerations:

1. Lebanon's **macroeconomic strategy** is clearly known, and the level of sophistication of the country's economic management team is high. While there is a strong need to address the growing macroeconomic imbalances, as noted above, a major USAID-sponsored activity to deal with macroeconomic policy is not necessary. The appropriate approach would be to provide technical expertise to the government to explore the merits, costs and benefits of alternative options for achieving macroeconomic balance.

2. The majority of Lebanon's **commercial policies** - those forming the environment in which private sector firms operate - are essentially sound. In fact, they are among the most "market friendly" in the region. To be sure, a number of important commercial policy impediments remain in place, and some have been identified in this report. Nevertheless, any initiative directly solely toward improving commercial policies would not be productive. In view of Lebanon's unique circumstances, it would be more useful to address the issue of commercial policy constraints within the context of overall constraints facing productive enterprise.

3. A key constraint to new investments in productive activities can be summarized as **lack of confidence and direction**. This can be attributed in part to factors (e.g., regional political uncertainty, growing deficits and indebtedness) which are beyond the control of businesses, but also to a lack of consensus on a vision for the economy and hence insufficient investment in modernization in many industries.

Based on these considerations, it is proposed that the core set of activities under USAID's sponsored initiative be organized around the concept of "industry cluster" strategies. Industry cluster initiatives provide a powerful framework for economic development strategies. They capture economic relationships within specific industry sub-sectors, and provide a set of tools to design and implement effective development strategies.

Industry clusters are attracted to or grow within specific regions or nations. They rely on an active set of relationships among themselves to ensure individual and collective efficiency and competitiveness. They are linked and held together by buyer-supplier relationships (forward and backward linkages), competitor relationships, common customers, flows of factors (labor, technology, capital) between firms, and other factors such as the increasingly important role of service providers.

The basic goals of industry cluster development approaches are as follows:

- ❑ Establish effective public/private coalitions organized around a reasonably defined, common set of challenges and opportunities.

- ❑ Identify through concrete examples key policy and institutional constraints to growth, and specify practical means to address these constraints.

- ❑ Define a consensus "vision" for industry cluster and economic growth, and on the basis of that vision develop actionable strategies to stimulate the growth of viable industry clusters, which will in turn serve as key engines of overall economic growth.

It is recommended that on the basis of Lebanon's current economic conditions and prospects, a set of industry cluster development initiatives be supported by USAID. This is most likely to fit the unique needs of Lebanon. It is proposed that three industry cluster activities be undertaken, one each for **light industry and agro-industry**, **regional business services**, and **tourism**. Each of these clusters fits Lebanon's economic assets and is important to the future of the economy.

A small working group will be established for each industry cluster. The working groups will include participants from the private sector, government and academia. Participants will be selected as individuals who have a strong knowledge and understanding of their respective industry cluster and the conditions it faces, demonstrate a commitment to overall Lebanese economic growth (beyond that of their agency, association or firm), and display a willingness to collaborate with their fellow participants on an objective basis.

The Industry cluster strategies will be implemented according to the following process. The basic objective of the working groups is to craft and implement focused industry cluster strategies.

Phase I: Initial Orientation and Start-Up Activities

Objective: Introduce stakeholders to the goals, process and desired outcomes of the process, and establish a strong foundation for project implementation.

Tasks:

1. Receive a briefing on the industry cluster technique and process.

2. Review the working group's operating rules, goals, roles and responsibilities.

3. Map the specific definition of the industry cluster -- the product/service categories included.

Phase II: Assessment of Regional Industry Clusters and Economic Infrastructure

Objective: Develop an in-depth understanding of the industry cluster identified, determine their competitiveness and future growth potential, evaluate the ability of the region's economic infrastructure to support the expansion of the cluster over time, and define a consensus vision for industry cluster growth.

Tasks:

1. Assemble and analyze data on the industry cluster, focusing on growth patterns, buyer/supplier relationships, concentrations of employment, productivity, value-added, etc.

2. Prepare an objective review of the state of relevant economic foundations. The economic foundations to be examined include the quality and quantity of the region's labor resources, availability of and access to capital and credit, natural resource endowments and constraints, the sophistication of technology applications, the region's physical infrastructure, institutional capabilities and the policy and regulatory environment.

3. Identify the respective industry cluster's "SWOTs" -- Strengths, Weaknesses, Opportunities and Threats -- as well as high potential markets, in the context of the cluster's competitiveness drivers.

4. Develop a consensus view or vision for the industry cluster in as specific terms as possible.

Phase III: Preparation of Cluster Development Action Plans

Objective: Craft an overall strategic plan for cluster growth, design detailed initiatives as part of the strategic plan, assign roles and responsibilities, and identify appropriate measures for monitoring implementation and follow-up activities.

Tasks:

1. Determine the general means and requirements needed to achieve the cluster vision by enhancing the competitiveness of the entire "value chain" of the industry cluster (the collective firms, support institutions and processes involved in the entire value chain of the industry -- input suppliers, producers, marketers, service providers, packagers, etc.). On the basis of this information, prepare an overall cluster development strategy.

2. Specify a select set of achievable, industry specific initiatives. These will include both policy and administrative reform actions that fall under governmental responsibility, and investment and other actions that fall under the responsibility of private businesses, operating individually and collectively.

3. Prepare detailed implementation action plans and identify specific roles and responsibilities.

4. Determine the institutional mechanisms required to implement the cluster action plans, monitor progress, and ensure completion of tasks assigned.

5. Integrate the findings generated by cluster leadership groups and provide a synthesis analysis, strategy and implementation action plan.

Lebanon faces a bright economic future if the nation – both the government and the private sector – can successfully address the near-term and medium-term macroeconomic conditions caused by the build-up of the government's indebtedness, which in turn has resulted from the need to rebuild the economy's foundations. This proposed initiative is intended to contribute to that goal.

II. LEBANON'S DOMESTIC ECONOMIC PERFORMANCE

Lebanon's domestic economic performance is often perceived, whether appropriately or not, through the prism of Lebanon in 1974, which remains the reference point or benchmark from which Lebanese measure their economic status. There is a clear tendency for many Lebanese to believe that the country's previous position as the most open and prosperous country in the region and the center for regional trade, finance, education, medicine, tourism and culture can be recaptured.

A more realistic approach, and one held especially by the younger generation of Lebanese professionals, is that while the economy took a "time out" for a protracted war lasting over 15 years, the rest of the world moved on, and so the conditions and lifestyles of 1974 cannot be restored. In any case, from an analytical standpoint it is appropriate to examine Lebanon's economic performance in three separate time frames: Pre-war Lebanon, the war years, and the post-war experience.

Assessing the nation's economic performance is rendered difficult by the dearth of reliable statistics on economic activities. The last normally compiled publication of Lebanon's national accounts and other important statistics was for 1972. Estimates and projections for 1973 were made, but not published due to the onset of war at the beginning of 1975. The Council for Development and Reconstruction (CDR) prepared overall estimates of the national accounts for 1977 as an aid to planning. Its figures were based on such limited indicators as were then available.

The CDR replaced the previous Directorate General for Statistics with the Central Statistics Office in 1979, but it began truly functioning only in October 1994. Since 1996 selected Lebanese economic statistics have been published, and recently a series of surveys of business establishments and of households has now been completed. As the body of data improves, published statistics will improve markedly in quality. This process is far from complete, however, and figures quoted in this report should be considered indicative of trends and orders of magnitude rather than firm summations of actual economic conditions.

Pre-War Economic Performance

Looking first at Lebanon's pre-war performance, despite occasional disturbances, the economy achieved solid economic growth and rising incomes over the period between 1950 and 1975. Yearly GDP growth in real terms averaged 6 percent, and inflation was held to an average of 3 percent annually. Per capita income was estimated in 1974 (complicated by the fact that there has been no official census in Lebanon since 1932) to be $634, approaching that of Portugal and about three times the levels prevailing in Egypt or Jordan.

In the mid-1970s, Lebanon was considered a middle-income country. During this period the ratio between consumption and domestic savings stayed relatively constant, with consumption accounting for 82 percent of GDP and domestic savings for 18 percent. From the mid-1960s to the mid-1970s, the contribution of agriculture to the economy declined from 11 percent to around 9 percent. Industrial activities contributed about 21 percent of GDP throughout the period, with services increasing from 68 to 70 percent. The exchange rate was relatively stable and averaged 2.9 Lebanese pounds to the dollar. Net capital inflows and invisibles covered the even then chronic trade deficit, contributing to ample foreign currency reserves at the Central Bank. Government revenues in that period equaled 20 percent of the GDP, but expenditures were only 15 percent, generating budget surpluses. The degree of "dollarization" – the percentage of domestic bank deposits denominated in foreign currencies – was about 25 percent.

Lebanon's enviable record resulted from a combination of geography, culture and history. In a world not yet linked globally in terms of communications and technology, Lebanon was geographically well situated to serve as an intermediary between Europe and the Near East, as well as to act as a business and financial center for the regional market. The nation's cultural diversity, social liberalism and dedication to private enterprise and an open economy made Lebanon attractive to Europeans and regional nationalities, and provided the milieu in which the Lebanese could develop their own skills.

History contributed to Lebanon's fortunes up to 1975 through both "negative" and "positive" regional developments. The negative factors included the emergence of socialist, state-directed economies in neighboring countries such as Egypt and Syria, which made Lebanon in contrast even more attractive as a center for finance and trade. In addition, the effective closure of the port of Haifa to Arab trade in 1948 removed a major competitor for Beirut. On the positive side, rapidly increasing petroleum revenues in Saudi Arabia and the Gulf states increased demand for its financial and other services and provided an attractive job market for skilled Lebanese professionals.

Lebanon's economic growth and prosperity were not equitably distributed within the country. Agricultural areas in the north, in the south and in the Bekaa valley benefitted from the nation's growth, but not in proportion to gains achieved in the Beirut, Mount Lebanon and the coastal areas. These economic disparities contributed to growing social and political tensions.

The Impact of War

As a result of Israeli-Arab conflict and ongoing regional strife, and due to both internal and external forces, Lebanon became a frontline state in the Arab-Israeli conflict. Lebanon became the recipient of well over 300,000 Palestinian refugees. With the added burden of internal political activism, the growing discontent of certain groups, and disparities in the distribution of power and wealth within Lebanon, the situation deteriorated into civil war in 1975.

The war was episodic but long lasting. The protracted war wreaked great physical damage, virtually marginalized the central government and seriously weakened the country's economic and social institutions. Individual Lebanese who lived through this turmoil were forced to place their highest priority on assuring personal safety and securing their economic survival.

Very little is known quantitatively about Lebanon's economic performance during the war years, but everyone knows that it was poor, at best. The nation's tourism, financial and trading activities, the pillars of the economy, all but disappeared. A host of factories, both large and small, were bombed repeatedly. Land mines were set in both rural and urban areas. Many entrepreneurs and their families fled the country in order to gain personal security. Retail establishments catering to tourists as well as affluent Lebanese closed their doors. Levels of per capita income and standards of living fell precipitously. In short, the nation was devastated by a continuous downward economic spiral that led eventually to little more than subsistence activities.

With concerted diplomatic efforts from a number of countries, a basic political accord was crafted in 1989. Central government authority was largely reestablished in 1990-1992, and with the election of Rafic Hariri as Prime Minister in October 1992, Lebanon entered into a new era in which its citizens hoped to regain the country's previous status of prosperity and liberal civil institutions.

Recent Economic Achievements

The initial transition from civil war to a peaceful society was tumultuous in economic terms. In 1990, Lebanon's GDP is estimated to have shrunk by around 14 percent. However, in 1991 the economy bounced back strongly, with growth estimated at 38 percent. In 1992, inflation on the order of 120 percent triggered a flight from the pound and the exchange rate in September of that year reached L£2,830 to the dollar. Net GDP growth nevertheless was estimated at 4.5 percent in 1992.

Over the past few years, economic activities have been closely associated with Lebanon's reconstruction efforts. Much has been accomplished in terms of restoring Lebanon's physical infrastructure. The telecommunications system has largely been rebuilt, and two mobile telephone systems have been established. Electric power has been restored to a level where most of the country has 24-hour a day power. Much of the water supply system now functions and major construction projects are under way for roads, the airport, the port of Beirut and public buildings. Private construction has also been active in restoring or building hotels, offices, shops and apartments. Seventy percent of the construction activity has taken place in Beirut and Mt. Lebanon, which means that Beirut has come a long way towards reconstruction since the end of the civil war.

Fueled by the construction boom, Lebanon experienced GDP growth rates of 7.0 percent in 1993, 8.0 percent in 1994 and 6.5 percent in 1995. This strong expansion has fallen off in recent years. In 1996, partially as a result of the Israeli air attacks and resultant economic damage and political uncertainties, the growth rate declined to 4.0 percent. In 1997, the growth rate decreased further to 3.5 percent due to a decline in exports, and there is some question as to whether 1998 growth will amount to as much as 2.0 percent.

The structure of Lebanon's economy has changed relatively little from pre-war to post-war times, as can be seen in the following table. During the war, trading and other services were handicapped, giving agriculture a proportionate boost. At present, however, agriculture is of even less importance than previously thought. The share of industrial output has returned to that in pre-war years, and tourism and other services are again becoming an important element in the economy. Current estimates of per capita income in the $4,000 range place Lebanon again in the ranks of middle income countries. In purchasing power terms, however, income levels are believed still to be 10-15 percent below the levels achieved in 1973, and there are substantial numbers of Lebanese living in poverty.

Composition of Lebanon's Gross Domestic Product

	1974	1984	1994
Services	68 percent	60 percent	69 percent
Industry	23 percent	25 percent	24 percent
Agriculture	9 percent	15 percent	7 percent

The rebuilding process, together with increased income, has greatly expanded Lebanon's merchandise imports. In 1997 imports were valued at over US$7.0 billion, offset partially by recorded exports of $1.2 billion. This represents a far greater dependency on imports to satisfy domestic consumption than in the 1970s. This means that Lebanon can maintain current consumption and savings levels only through substantial net inflows of services income, capital, and remittances.

Foreign direct investment has been more limited than expected. Most foreign investment inflows have been directed toward real estate and portfolio investments. An initial surge of investment in real estate projects has resulted in a surplus of apartments and office projects relative to current demand. At a minimum, equity capital invested in such projects remains illiquid until and unless the market trends upward. At its worse, debt holders take over the properties and sell them at discounted prices, depressing the market and discouraging further investment. A large proportion of capital flows into Lebanon have been in the form of portfolio investments, taking advantage of the relatively high rates of return, as well as limited foreign exchange risk on financial instruments denominated in foreign currencies.

Investment in productive activities has been made, especially in selected areas such as construction materials and banking, but this trend has witnessed serious deterioration. Factors inhibiting productive investment include:

- Perceived political risks, mostly external, but some internal.
- Apprehension over the direction of Lebanon's economy and concern over the sustainability of the government's macroeconomic strategy (discussed below).
- The small size of the local market.

- High local costs for labor, real estate, transportation, etc., along with the belief that the Lebanese pound is overvalued, which detract from price competitiveness in regional/world markets.

- The availability of attractive investment alternatives, including Treasury securities, fixed deposits, and carefully selected real estate investments.

A number of policy-induced disincentives also constrain investment in productive activities. These include but are not limited to the following:

- Lebanon lacks effective protection for intellectual property rights, creating a disincentive for high technology and media investments.

- There is no formal competition policy, which adds to the perception that Lebanon's economy is controlled by a small number of business groups.

- There are serious concerns regarding Lebanon's labor policy, especially the issue of social security administration, costs and services.

- Despite considerable publicity about free zones, Lebanon has not put into place a truly effective free trade zone regime.

- The tariff structure impedes industrial activity and distorts agricultural trade but is difficult to change since it is a major source - approximately 45 percent - of government revenue.

- Finally, dealing with Lebanese government bureaucracy is not always an easy or expeditious process.

Investors can accept -- and discount for -- political risk and structural inefficiencies when the economic returns are sufficiently high. Alternatively, if the prospective economic returns are modest, then the policy and overall operating climate must be very attractive. Currently, the structure of disincentives and incentives tilts in favor of nonproductive rather than productive investments.

The world has changed during the period that Lebanon effectively receded from the international economic scene. The tremendous growth of oil revenues in Saudi Arabia and the Gulf has come and gone. Dubai, Bahrain and Kuwait have emerged as financial/entrepot centers. The economies of Egypt and Turkey have expanded greatly, and Jordan has changed from a sparsely populated state to a modern economy in terms of business, finance and trade.

The expansion of the European Union, the emergence of East and Southeast Asian economies, and more recently the collapse of the Soviet Union and eastern bloc all have made the world of the 1990s a vastly different place.

Over this period, Lebanon did not participate in many rounds of growth, modernization and competitiveness enhancement. In fact, in many respects Lebanon's economic operating environment deteriorated. The tendency for the government to intervene in the economy, begun out of necessity during the war years to solve pressing social or economic problems, has nevertheless led to distortions in the economy which are largely unacknowledged. In addition, many segments of the private sector have not made the investments needed to restore international competitiveness.

In sum, Lebanon has made remarkable progress in the short period since 1992, but its progress has now leveled off considerably. There is no current evidence suggesting that the recent economic downturn will be reversed in the near-term future. This in turn gives rise to the need for concerted efforts to restore the nation's economic momentum.

III. LEBANON'S INTERNATIONAL ECONOMIC PERFORMANCE

Lebanon historically has been a service economy, importing more goods than it exports, and covering its trade deficit with surpluses in its services and capital accounts. The country has run overall balance of payments deficits only twice in the past twenty years. But now under the pressure of heavy expenditures for reconstruction and the general rebuilding of the economy, the merchandise trade deficit has grown to tremendous proportions for a small economy like Lebanon. The balance of trade was reported by Lebanese Customs to be in deficit in the range of US$6.5 billion in 1995 and remained at that level in 1996. Estimates for 1997 indicate an increase in the trade deficit to US$6.8 billion, due primarily to a reduction in exports, from US$1.0 billion in 1996 to US$0.6 billion in 1997.

As Lebanon has rebuilt its physical and industrial base starting in 1991, exports rose substantially, more than doubling between 1991 and 1996. However, these gains were more than offset by steadily rising imports, leading to a continuous rise in the trade deficit. Total exports and imports as reported by the Higher Customs Council are:

Lebanon's Merchandise Trade
(Millions of US dollars)

Year	*Exports*	*Imports*	*Balance*
1991	490	3,748	-3,258
1992	551	4,251	-3,700
1993	458	4,939	-4,481
1994	572	5,990	-5,418
1995	824	7,303	-6,479
1996	1,018	7,559	-6,541
1997	642	7,456	-6,814

Lebanese exports comprise a wide variety of products. The largest single export category in 1997, accounting for 17.1 percent of the total, is textiles. This is followed by chemical products (15.3 percent), metallic products (14.9 percent), electrical material (14.7 percent), jewelry (14.7 percent), and fruit and vegetables (14.0 percent). These six categories alone represented 90 percent of total exports.

Turning to imports, electrical equipment accounted for 15.5 percent of total imports, followed by vehicles (9.9 percent), mineral products (9.6 percent), metals (8.1 percent), jewelry (7.7 percent) and chemical products (7.2 percent). A disquieting fact is Lebanon's food trade balance, which showed a deficit of US$1.4 billion in 1997, a level comparable to that in 1996.

Lebanon's exports are directed principally to the Middle/Near East. The major export markets in 1997 were:

Saudi Arabia	15.1 percent
United Arab Emirates	9.1 percent
United States	6.1 percent
Syria	5.9 percent
France	5.0 percent
Kuwait	4.5 percent

These six countries collectively account for about 48 percent of recorded Lebanese exports. Over 50 percent of Lebanese imports come from Western Europe and the United States and Japan, with Italy the largest single supplier at 13 percent of the total.

Lebanon expects to increase its trade principally with its neighbors in the region. A free trade arrangement negotiated with Syria is expected to result in a common market for the two countries within the next three years. Further economic liberalization and resultant economic growth in that economy of 16 million people is believed to represent a major growth opportunity for Lebanon. Beyond Syria lies Iraq, which in the intermediate term (assuming an end to the present economic sanctions) could again offer an attractive market for Lebanese producers and traders. Lebanon remains interested in the Arab Common Market initiative under the belief that Lebanon stands to benefit from such a development.

Lebanon's adherence to the GATT/WTO is under discussion. One sticking point is the lack in Lebanon of effective Intellectual Property Rights protection. In the interim, Lebanon lacks preferential access for most of its products in the European and U.S. markets.

Lebanon is also in trade negotiations with the European Union (EU) as part of the latter's New Mediterranean Policy announced in December 1990 and reinforced by the November 1995 Declaration of Barcelona. The EU's strategic objective is to develop a framework in which issues of socio-political stability, economic development, trade and migration from its populous and under-developed southern flank can be addressed. Also, the EU seeks assert a stronger role in Mediterranean affairs *vis-a-vis* the United States. Partnership agreements have been signed between the EU and Tunisia, Morocco and Israel, and negotiations are under way with Egypt, Jordan and Lebanon. A first draft for the EU-Lebanon partnership agreement was signed in February 1996. Signature of a final agreement is still pending.

Such a partnership agreement offers potentially significant short-term and longer-term effects for Lebanon which go directly to the issues surrounding the country's future growth and development. Basic elements of these agreements involve:

- ❒ Encouragement of regional dialogue on issues of mutual concern, i.e., creation of a forum for European rather than U.S. involvement/influence on the region;

- ❒ Liberalization of all trade and services flows and the creation of an EU-Mediterranean Free Trade Zone by 2010;

- ❒ Cooperation in matters of health, education and population policy developments with a view to bring migration under control; and

- ❒ Financial support to developing states in the region (starting with a $6.4 billion program for the 12 prospective partners for the period 1995-1999) and access to the European Investment Bank (EIB).

As to trade in goods and services, the agreements call for the elimination of all direct and indirect barriers to trade in manufactures within 10 years of signing. Tariffs are to be eliminated reciprocally – after a five year grace period – over a period of 7 years. Agricultural products will remain subject to the EU's Common Agricultural Policy (CAP). Capital movements are to be liberalized, and free right of establishment will be granted for businesses.

For the longer term, a partnership agreement will force Lebanon to accomplish many important structural reforms, such as streamlining government operations, undoing legislative and regulatory constraints to trade, and moving towards privatization of utilities and many public services. The agreement will also lead to more competitive industrial and service sectors and permit Lebanese service providers open access to the EU market. It is also expected to provide for enhanced development of human resources and the transfer of technology.

For the short term, however, an agreement poses problems for Lebanon. For example, a lowering of tariff rates immediately translates into a loss of public revenue. Moving away from its current reliance on import levies as the principal source of revenue is a desirable strategy for the government, but will not be easy to implement. Increased import competition carries the risk that certain Lebanese manufacturers will not be able to compete and will be forced out of business. Current estimates are that as many as 40,000 to 50,000 jobs may be lost. Neither development would be welcome in view of Lebanon's present situation.

Coupled with concerns of some EU members that their economies would be threatened by free Lebanese access, this could well explain the apparent delay in formalizing the agreement.

A major issue confronting Lebanon arising from its severe trade deficits is its need to maintain balance in its current and overall payments balance accounts despite the deficit in merchandise trade. Only through preserving adequate foreign exchange reserves can Lebanon maintain the exchange value of its currency, and hence sustain sufficient confidence on the part of foreign investors to buy Lebanese public and private debt instruments. To date, Lebanon has been able to run current account surpluses, some of substantial amounts. How the trade deficit is covered is not clearly understood, but several factors appear to affect this balance:

- Despite a lack of official recognition, it is widely believed in the Lebanese business community that a substantial amount of exports are unrecorded, particularly those transported by land. The Government collects no revenues from exports and there is little incentive to record the movement of goods outside the seaports. It is also alleged that under invoicing is widespread and that there is substantial smuggling across the land frontiers. Quantifying this practice is impossible, but in view of the nearly $8 billion of imports recorded for a country of 3.1 million people, many of them living below the officially set poverty line, logic dictates that the actual levels of exports may considerably exceed those indicated by the recorded figures.

- Invisible income from services, principally tourism, is substantial. In 1996 the government estimated that net income from tourism exceeded $700 million. Nevertheless, statistics from the Central Bank indicate that Lebanon's net services income ranges from $50 to $100 million and so is not a major factor in covering the merchandise trade deficit.

- Remittance income from overseas Lebanese is widely credited with financing a significant portion of Lebanese household expenditures and imports. The large number of overseas Lebanese and their active interest in the home country are well known. On the other hand, it is widely recognized that non-Lebanese workers in the country, mostly Syrian, are sending remittances from Lebanon to their home countries. World Bank figures calculate net personal remittances to be in the range of $300 - $400 million annually, which is a modest figure compared to popular belief.

- The final and key element in the balance of payments is capital inflows from abroad. Some has been used for equity investment (e.g., in Solidère), and some for the purchase of offshore issues of Lebanese bonds, but much has gone to the banking sector to support both dollar-denominated, interest bearing accounts and purchases of Lebanese government securities.

Whatever the mechanism, the result of these flows has been overall balance of payments surpluses and rising foreign exchange reserves, which now total $6.4 billion. This level suggests to some in Lebanon that the government need not maintain its tight money and relatively high interest rate policies at quite their current levels. The April 1997, removal of the Central Bank's requirement that commercial banks hold 40 percent of their reserves in Treasury securities was one sign of policy relaxation but weak loan demand has inhibited any major change in the structure of bank portfolios.

Lebanon's public sector debt is overwhelmingly denominated in Lebanese Pounds, and the foreign portion of Lebanon's public debt is quite modest. Gross public debt by June 1997 is estimated to have reached L£23.3 trillion, of which L£2.3 trillion (about 14 percent) was external debt. In dollar terms external debt is about $2.1 billion, as against a net total public debt in the range of $12.5 billion. Current proposals by the government to float a foreign currency denominated debt issue of $2 billion, if carried out, would significantly change these ratios, but still leave Lebanon with an external debt of relatively modest proportions compared to many other countries.

IV. LEBANON'S MACROECONOMIC POLICY FRAMEWORK

It is important to acknowledge at the outset of any policy assessment that Lebanon's senior economic management team is sophisticated by both regional and international standards, and strongly supports appropriate policy principles. Policy makers embrace the desirability of private sector-led growth, and voice a common view against government intervention in the economy. These leaders are supported by a widespread national consensus in favor of market forces and private enterprise. Notwithstanding disagreements in other areas, the degree of unanimity on long-term economic policy is unique, and represents a strength upon which Lebanon can build an effective, unifying strategy.

The nation's fundamental dilemma regarding macroeconomic policy stems from the need to rebuild the economy and at the same time maintain socio-political stability, which implies high government expenditures, despite the fact that Lebanon's productive sectors are not yet ready to finance the fiscal burden through tax revenues. This in turn gives rise to concerns over the pace of reconstruction and the levels of government-provided employment and services. Once again it was the war that has created this dilemma.

To the extent that government persisted throughout the war years, its response to problems which arose was short-term in nature and uncoordinated with other measures. For example, unable to collect revenues, the government directed the Central Bank to print money in order to finance governmental operations, which led to hyperinflation and flight from the local currency. Dollarization was estimated to have reached 93 percent in 1987.

During the early 1990s, the Council for Development and Reconstruction (CDR) led a government planning effort which resulted in the National Emergency Reconstruction Plan (NERP), calling for an investment program of US$2.9 billion. The NERP was passed by the Parliament in late 1992. By that time, civil order had largely been restored, but the country was devastated and its surviving institutions barely functioned.

The government issued a series of major contracts in the 1993-94 period to initiate large scale reconstruction efforts. These would have to be financed through public debt. To support this initiative, macroeconomic policy was directed at bringing inflation under control and stabilizing the value of the currency. This strategy was largely successful. Rates of inflation have dropped to a range of 10-12 percent in recent years. The value of the Lebanese pound has not only been stabilized, but has appreciated to its current rate of L£1,525 to the dollar. This in turn has led to a decline of dollarization to a current level – in terms of bank deposits – of about 56 percent.

The government to date has been able to finance its deficits through the issuance of Treasury securities denominated in local currency in maturities ranging between 91 days and two years. Seventy percent of these securities are held by Lebanese commercial banks, and only 20 percent by individual investors. Returns on public debt instruments have reached as high as 28 percent, but now range between 14 and 18 percent depending on the length of maturity. For the banks, these have offered an opportunity to earn attractive returns on capital in the face of weak domestic demand for loan credit. The trend was reinforced by the requirement imposed by the Central Bank that commercial banks keep 40 percent of their required reserves in the form of treasury securities. This requirement was ended in March 1997.

The NERP evolved in 1994 into a more elaborate planning document, *Horizon 2000,* which envisaged a public sector investment program of US$17.7 billion for the years 1995-2007. Based on the historic ratio of an 85 percent contribution to GDP from the private sector, Horizon 2000 projected private investment of over US$42 billion over the planning period. To achieve this, Lebanon's GDP growth needed to be close to 8 percent annually. The planning document projected fiscal deficits through the period averaging 70 percent, with a 1991 peak of 91 percent, but disappearing in 2004 and turning into surplus by 2006. The problem that has arisen is that regardless of the precise current rates of growth, they are clearly much lower than those assumed and required for the *Horizon 2000* strategy.

The Lebanese government kept to its reconstruction plan with little deviation until late in 1997, when it acknowledged that some modification might be in order. The government's budgets postulate substantial shortfalls between revenues and expenditures, leading to increasing public debt and an ever increasing debt service burden. Aggravating the situation is the fact that government deficits have consistently exceeded the stated budget targets. To finance these deficits, the government's macroeconomic policy strategy has been to maintain control over the money supply both to reduce inflation and to provide interest rates high enough to make treasury securities attractive to investors.

Government Revenues and Expenditures
(Billions of Lebanese Pounds)

		Revenues			Expenditures			Deficits		
		Actual	Budget	Actual/ Budget	Actual	Budget	Actual/ Budget	Actual	Budget	Actual/ Budget
1997	Jan-Sep	2,719	4,100	66%	5,883	6,400	92%	3,164	2,300	138%
1996		3,534	4,025	88%	7,288	6,458	113%	3,754	2,433	154%
1995		3,033	3,150	96%	5,856	5,630	104%	2,823	2,480	114%
1994		2,241	2,246	100%	5,204	4,106	127%	2,963	1,850	159%
1993		1,855	1,701	109%	3,017	3,400	89%	1,162	1,699	68%

There is a growing consensus in Lebanon that continued large government deficits are unsustainable. Between 1994 and 1997, government revenues have represented between 15 percent to 18 percent of GDP. Budget expenditures for the same four years have amounted to one-third of GDP. Interest payments on the public debt now amount to about one half of the Government's proposed budgeted expenditures, which in effect means that interest payments absorb all the government's revenue. Net public debt is now equal to the whole estimated annual GDP of Lebanon.

The danger is that if uncorrected, Lebanon's ability to attract increasing amounts of foreign capital inflows may prove inadequate to cover the deficit, leading to a crisis of confidence, capital flight, and a difficult "hard landing" for the economy. Proposed solutions focus on both increasing revenues and reducing expenditures. Increasing revenues implies either new taxes or higher tax rates. Examples discussed have included increases in individual and corporate income taxes, and the introduction of either a sales tax or a value added tax. Each of these options needs to be examined with regard to potential equity impacts, likely macroeconomic effects and particularly the government's ability to collect such taxes. Another suggestion for deficit financing include drawing down the government's substantial deposit reserves to reduce the deficit, thus lowering interest rates, and permitting the refinancing of existing debt at lower rates of interest.

On the expenditure side, there are questions as to the efficiency of current government spending in terms of value received for money spent. On the other hand, the government has been faced with complaints about the lack of spending for social programs such as education, community rebuilding and agricultural improvement. One means of reducing government expenditures is privatization, but previous actions in this field were not well received by the public. The government is, nevertheless, attempting to shift selected public works projects, principally highways, to a Build-Operate-Transfer (BOT) mode whereby project financing will come from private sector sources.

It is clear that **in the near term**, Lebanon will not “grow” itself out of its public sector deficits or cover its public debt. This suggests that the burden of adjustment will rest on new fiscal measures. Ultimately, however, the only viable solution to the nation’s macroeconomic dilemma is growth in productive economic activities. By creating new income and employment, these not only will generate increases in government revenues, but also will reduce pressures for the government to provide employment and social services.

V. LEBANON'S ECONOMIC/COMMERCIAL POLICY FRAMEWORK

As in most parts of the world, Lebanon's policy-makers have recognized the need for a sound commercial and economic policy environment which maximizes competitiveness, efficiency, and the creation of productive employment. After several years of concerted efforts to re-establish a competitive commercial environment, it is useful to stand back from the process to evaluate the strengths and remaining weaknesses in Lebanon's commercial policies.

Given the importance of a business-friendly commercial policy environment for private sector development, it is imperative for policymakers to identify feasible policy alternatives, and to assess their effectiveness. To this end, cross-country experiences can be utilized to examine specific policy approaches and the lessons learned from their successes and failures in enhancing economic performance. Cross-country data is also useful for conducting policy benchmarking, which is an effective technique for assessing the comparative position of a country's commercial policy regime against its competitors in attracting international investment and trade.

This section presents the findings of an analysis conducted by SRI to identify those policy practices which are conducive to private sector development and sustained economic growth. The methodology is designed to allow cross-country comparisons of overall commercial policy regimes through summary country policy scores, which describe the degree to which commercial policies are business-friendly as well as competition-based.

The policy variables analyzed are classified under nine categories:

1.	**Business start-up**	**6.**	**Domestic investment**
2.	**Pricing\interest**	**7.**	**Foreign investment**
3.	**Import**	**8.**	**Labor**
4.	**Export**	**9.**	**Taxation**
5.	**Foreign exchange**		

The policy variables were categorized so that they could be assessed as policy groups in forming the overall commercial policy environment. Such classification can also accommodate cross-country comparison in each individual policy category. SRI designed a rating system which assigns summary policy scores to each nation.

POLICY VARIABLES INCLUDED IN THE DATA SET

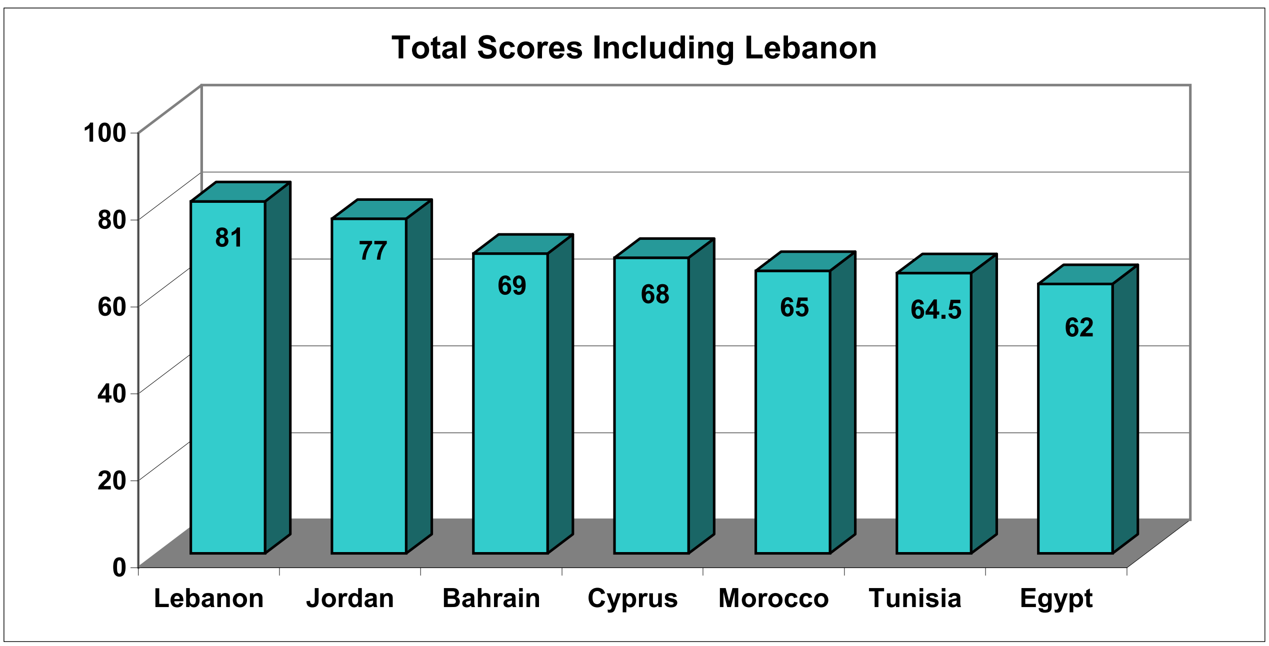
Policy Category	Policy Variable
Import	Mean Trade-Weighted Tariff Tariff Variance All Non-Tariff Barriers
Export	Export Taxes Export Restrictions Export Income Tax Exemptions Duty Free Imports
Tax	Minimum Corporate Income Tax Rates Top Corporate Income Tax Rates Minimum Personal Income Tax Rates Sales Taxes + Value-Added Tax Rates
Domestic Investment	Income Tax Holidays Duty Exemptions Other Incentives: Accelerated Depreciation Investment Allowance R&D Incentives
Foreign Investment	Direct Investment Restrictions Expatriate Employment Restrictions Differential Treatment Between Domestic and Foreign Investment Dispute Settlement Mechanisms
Business Start-Up	Business Licensing Business Registration Approvals
Pricing & Interest	Price Controls Price System Interest Controls Credit Allocation
Foreign Exchange	Exchange Rate System Foreign Exchange Level Foreign Exchange Restrictions Profit Repatriation Restrictions Capital Repatriation Restrictions
Labor	Hiring/Firing Flexibility Minimum Wage Wage Controls

Under this system, both quantitative and qualitative information is converted into a set of policy scores. The scores of the policy variables within the same policy category are then summed and harmonized. The Total Score (TS) for each country is obtained by summing the weighted scores from all the policy categories. The maximum achievable Total Score for a country is 100. Total Scores can be compared across countries as a summary description of the commercial policy environment. In addition, comparisons and benchmarking can be conducted in each policy category by comparing the Policy Category Scores across all countries or groups of countries.

Benchmarking Lebanon's Commercial Policies Against Regional Countries

This section compares Lebanon's commercial policy scores with those of other countries in the Middle/Near East. The countries were chosen as competitors or models against which Lebanon can be benchmarked in terms of "policy competitiveness."

The following countries were chosen as regional benchmarks: Bahrain, Cyprus, Egypt, Jordan, Morocco and Tunisia. The countries in this group have commercial policy scores ranging from 62 to 81 points. As one can see from the following chart, Lebanon



leads the group with a very strong overall scores of 81. With the exception of Jordan, Lebanon's scores are significantly higher than those of other nations in the region. Lebanon scores nineteen points higher than Egypt. Egypt (62 points), Tunisia (64.5 points), and Morocco (65 points) have the lowest scores among those selected for comparison. These scores place most of these countries in the middle of SRI's worldwide ranking of commercial policy scores.

Scores in the specific policy categories indicate that some commercial policies are consistent across the region while others vary greatly (see table below). Most countries have similar scores for export and pricing policies. However, other policy categories display a significant divergence in scores. For example, country scores for import, taxation and labor policies vary substantially. Lebanon compares extremely favorably to its neighbors in most categories. It has one of the highest scores in five out of the nine categories: Import, export, taxation, pricing and labor policies.

REGIONAL COMMERCIAL POLICY SCORES

Country	Imports	Exports	Tax	Invest-ment	Foreign Direct Inv.	Business Start-up	Pricing/ Interest Rates	Foreign Exchange	Labor	Total
Lebanon	***12***	***8***	***16***	***4***	***4***	***4***	***9***	***16***	***8***	***81***
Jordan	12	6	16	8	6	4	9	8	8	77
Bahrain	8	6	16	4	6	6	9	8	6	69
Cyprus	8	8	12	4	8	6	6	12	4	68
Morocco	8	8	4	6	8	6	9	12	4	65
Tunisia	4	8	8	6	6	8	7.5	12	5	64.5
Egypt	8	6	4	6	5	4	9	16	4	62
Average	8.6	7.1	10.9	5.4	6.1	5.4	8.4	12.0	5.6	69.5

VI. UNIQUE FACTORS AFFECTING LEBANON'S ECONOMIC STRATEGY

Any strategy designed to stimulate a nation's productive economic activities should be based on the country's actual conditions, opportunities and constraints. Many patterns of environmental factors and performance can be held in common by a number of countries, and individual conditions can be similar to those experienced in other countries. Nevertheless, each nation is unique and faces a singular blend of economic, social and political factors that collectively determine its economic prospects. Accordingly, each requires its own tailored approach to fit its particular circumstances.

Lebanon displays a number of special factors or "drivers" that represent conditions of reality that need to be taken into consideration in the design and implementation of an effective economic strategy. These include both constraints that need to be addressed and opportunities upon which a plan should capitalize.

Constraint Drivers

Externally-imposed political risk. Perhaps more than any other nation in the region, Lebanon is subject to outside political and military forces that are beyond its control, materially affect internal political stability, and considerably raise the level of uncertainty and risk facing investors. As a result, there is a tendency for available capital to be directed toward activities which are deemed to be "hedged" *vis-a-vis* potential political risk. These typically include financial instruments and real estate, but not productive investments in plant and equipment which are more vulnerable to loss in the event of political/military strife. Heightened political risk also imposes a "premium" in the form of higher rates of return on investments that are required to accommodate higher rates of risk.

> ***Strategic Implications:*** Other than participating in and supporting the peace process, the role of Lebanon in achieving regional political stability is limited. Therefore, until regional stability is achieved, Lebanon should pursue a two-pronged strategy. First, economic actors will have to accommodate political risk as an inherent element of the economic environment, as have other countries in similar circumstances. Second, actions should be taken to develop Lebanon into the best location (policies, services, quality inputs, etc.) for doing business in the region, to offset political risk to the maximum extent possible.

The cost of physical reconstruction. Fifteen years of war, much of it conducted in urban settings, devastated Lebanon's infrastructure and capital stock of buildings and physical facilities. The cost of restoration is enormous, and is the key factor driving the nation's macroeconomic policies and performance. Capital investment associated with reconstruction not only affects conditions (e.g., high interest rates) facing investors in the near term, but is also building a "mortgage" on the Lebanese government and people for many years to come.

> ***Strategic Implications:*** The Lebanese government and society have no option other than bearing the cost of rebuilding the nation's infrastructure and physical facilities. The phasing and prioritization of this enormous task must be planned carefully to avoid macroeconomic instability, achieve the necessary socio-economic balance, and attain growth in productive activities as quickly as possible in order to maximize the nation's ability to finance reconstruction.

The need to modernize "soft" infrastructure. Lebanon's prolonged war left a need that is less visible but no less urgent than reconstructing the nation's physical infrastructure. This is the requirement to install modern "soft" infrastructure -- the institutions, processes and administrative systems which collectively support productive economic activities. The effect of war was that no efforts were made to upgrade the quality and availability of effective "systems" such as tax and tariff administration, technical training, computerization and advanced information technologies, and efficient organizational management structures. This is true for both government agencies and private sector firms, neither of which was able to invest in initiatives to improve quality and competitiveness. Since many governments and industries in other nations have aggressively pursued various forms of "structural adjustment" through downsizing, re-engineering and other efficiency measures, most Lebanese institutions stand at a disadvantage *vis-a-vis* their competitors in other countries.

> ***Strategic Implications:*** Public and private sector leaders need to acknowledge the importance of soft infrastructure and consequently establish programs to install/upgrade these systems as important components of their overall reconstruction efforts. One of the key tasks of the proposed industry cluster working groups described below will be to identify critical soft infrastructure requirements.

The small size of the market. With a population of less than four million and per capita incomes below those prevailing in pre-war years, Lebanon is not a large market by international standards. As a result, the local market alone is not sufficient to provide the economies of scale necessary to support competitive, productive activities in certain areas, especially manufacturing requiring high volume throughput.

> ***Strategic Implications:*** Lebanon should not expect to become a major global-scale producer of any good or service. However, Lebanon's trading heritage and proximity to other countries in the region can in effect expand the size of the market

to encompass neighboring markets. More importantly, the relatively small size of the Lebanese market and needs for income-generating activities suggests that the nation does not necessarily need large-scale operations, but rather can concentrate on "niche" activities with high levels of value added.

Lack of consensus on Lebanon's economic future. There is no easily discernible common view or "vision" on where the economy will be in the future, or more importantly on what should be the appropriate direction for the Lebanese economy in the future. While this in not necessarily unique among nations, countries (and regions within countries) of comparable size which have implemented successful economic development strategies have usually established a strong degree of consensus on where their economies will go and/or where they should move toward over time.

> ***Strategic Implications:*** Lebanon's government, business community and academic establishment should individually and where possible collectively contemplate and craft a general consensus on a vision for the nation's economic future. The USAID-sponsored initiative described below will contribute to this process.

Opportunity Drivers

The pro-market orientation of the government and people. Unlike many other countries in the region, Lebanon's economic prospects are heightened by the strong belief in private sector-led growth held not only by the government, but also by all segments of society. This outlook precludes the need to reform a wide battery of interventionist government policies, and in addition provides constituencies and support for the removal of remaining policy obstacles.

> ***Strategic Implications:*** Lebanon does not require major efforts to change basic attitudes and policies, and in fact can leverage the country's pro-market stance in both its development initiatives and its investment promotion activities. In addition, reform-oriented activities to remove existing policy obstacles should be accelerated.

The heritage of entrepreneurship. The Lebanese are unique within the region for the degree of entrepreneurship they display. In fact, they are known throughout the world as business minded individuals. This characteristic can serve as a strong asset for both domestic and regional economic ventures.

> ***Strategic Implications:*** The inherent entrepreneurship of the Lebanese people should be acknowledged as a "national asset" that can and should be nurtured in economic development activities. Specifically, efforts should be made to provide

entrepreneurs, especially those operating or contemplating small and medium sized businesses, with the resources (technology, capital and credit, training, information, etc.) needed to expand or initiate new operations.

The Lebanese "Diaspora." For decades if not centuries, Lebanese individuals and families have moved to other locations throughout the world for both economic and political reasons. In their new countries, like other hard-working groups, they have established thriving businesses and accumulated income and wealth. At the same time, the overseas Lebanese have for the most part retained strong ties to their family members in Lebanon and to the home country itself. Thus the overseas Lebanese constitute a major economic asset, both currently and prospectively. Inward remittances support family incomes and the nation's balance of payments. Overseas Lebanese invest heavily in both government and private sector securities. For example, of the 60 percent of Lebanon's stock market equities held by non-residents, over one half (35 percent) are held by non-resident Lebanese. More important, as one looks to the future, the global network of enterprises operated by Lebanese provides a valuable foundation on which new productive activities can be based.

Strategic Implications: Similar to Lebanese entrepreneurship, the global reach of the nation's people and businesses represent a true economic asset. Many initiatives geared toward generating new productive activities, such as tourism, regional trade and finance, and business services, should explicitly take advantage of this network.

VII. BALANCE SHEET ASSESSMENT FOR ECONOMIC GROWTH

While economic and commercial policies form the critically important environment for productive activities, a nation's economic performance is affected strongly by its various endowments of resource inputs, which collectively determine its comparative advantage. Equally important is the ability of economic actors to enhance their country's resource strengths and overcome resource constraints -- essentially transforming comparative advantage into competitive advantage.

One way to gauge an economy's overall strengths and weaknesses is to prepare a "balance sheet assessment." Simply stated, this technique identifies both "assets" and "liabilities" in key input areas, such as natural resources, labor, capital, infrastructure, and so forth. These economic inputs are examined in both absolute and relative terms in order to provide a frame of reference for various development initiatives at both the macro and micro level. This section presents a brief assessment of Lebanon's general economic resource balance sheet.

Natural Resources

Lebanon's natural resources are limited. The nation possesses little or no petroleum nor other major mineral resources other than key inputs to cement production. Historically, Lebanon had extensive forests and still produces wood both for use as fuel and as a raw material for construction materials and furniture. Its forest resources are declining, however, and there is concern that deforestation has already exceeded prudent limits.

Adequate rainfall, especially along the Mediterranean coast, supports agricultural production. Rivers between the Lebanon and Anti-Lebanon mountain ranges permit irrigation of agricultural lands in the Bekaa valley. There is also arable land in both the northern and southern parts of the country.

Physical Geography

Lebanon's mountainous topography and extensive coastline have provided for a moderate, "Mediterranean" climate. The mountain ranges serve to trap rainfall from the prevailing westerly winds approaching from the sea and providing the base for agriculture, animal husbandry and forestry. The height of the Mount Lebanon range east of Beirut results in snow cover for much of the winter and makes Lebanon the only site in the Near East to offer skiing. The mountains also provide moderate capacity for hydroelectric power generation.

Lebanon's location at the eastern end of the Mediterranean Sea midway between Anatolia and the Nile delta has for millennia made Lebanon a trading center for the passage of goods between Europe and Western Asia. This role has been supported by the rugged coastline endowed with a number of locations suitable for ports.

Labor

Lebanon's economically active population (labor force) is estimated at around 900,000. Before the war, Lebanon was noted for the quality of its educational system and the advanced skills of many of its citizens which staffed the nation's medical centers, universities, financial institutions, construction firms and trading houses. The civil war gave rise to an exodus of Lebanese to foreign countries. Many laborers moved to Saudi Arabia and the Gulf states, while professionals went there as well as to Europe, the United States and elsewhere.

Literacy and technical skills are still higher in Lebanon than in many countries in the region, but the public educational system has been severely weakened and private education has become increasingly expensive. The economy has not grown sufficiently rapidly to absorb new graduates of universities and technical institutes, and there is at least anecdotal evidence suggesting that emigration still exceeds the number of Lebanese returning. In addition, there is some question as to whether there is an adequate supply of sufficiently skilled workers to fill middle level and support positions.

A substantial number of Lebanese workers are unionized, but while the National Labor Confederation is active politically, organized labor seems to have little influence presently on government policy. Lebanese wages are relatively high. For example, apparel manufacturers mention paying wages of around US$3.00 an hour, which is low by developed world standards but higher than prevailing wages in most other developing countries. Lebanese workers are said to require monthly salaries of $350 to $500 a month to support a reasonable standard of living. The legal minimum wage amounts to $290 a month. Employment of Lebanese is further complicated by the financial requirements of the Social Security system, which covers both medical and retirement benefits. Many employers find the Social Security system burdensome, and report that it is difficult to predict which services the system actually provides.

The end result of labor market conditions has been that most lower skilled jobs in such fields as construction and agricultural field work, as well as service jobs like domestic employees, are filled by foreign workers for whom Lebanese labor and social laws are rarely applied and for whom the wages paid are more likely to fall in the $200 - $250 per month range. As many as 95 percent of the foreign workers present in Lebanon are believed to be in the country illegally. Their number is unknown, but estimates of 600,000 and above are considered reasonable. The majority of these foreign workers are Syrian, but there are also significant numbers of Sudanese, Sri Lankans and Filipinos.

Capital

Prior to the war, Lebanon century excelled as a banking and financial center. The law establishing the Banque du Liban (the Central Bank) in 1963 institutionalized Lebanon's policy of a free market for foreign exchange and no restrictions on the movement of capital. This policy, together with bank secrecy laws and a *laissez faire* economic policy by the government, allowed Beirut to flourish as a regional financial center. This role was severely damaged during the civil war.

The banking industry in Lebanon has worked hard in recent years to rebuild and modernize its capacity. Lebanon's banking system is certainly well developed and relatively sound. Even if Lebanon no longer acts as the premier financial center for the region, it is moving toward becoming a financial center once again. Over the past two years, for example, Lebanese banks have begun to act as lead institutions in the management of bond issues available to international investors. To date, most of these issues have been for major Lebanese companies, but their capability is growing. The stock market has reopened, and while small, offers the possibility providing a regional equity market for companies seeking financing.

The Central Bank has foreign exchange reserves currently in the range of $6.5 billion dollars and the government seems committed to policies of controlling inflation and maintaining the value of the national currency. One clear result of tight monetary policies has been high interest rates, which as dampened demand for loans. Commercial lending is weak because of lack of demand, rather than due to inadequate resources.

As in many developing countries, there are complaints regarding access to financing for small and medium enterprises. Commercial banks often consider smaller and newer enterprises as entailing greater risks, which together with a legal framework making foreclosure on real estate or other collateral difficult, inhibits their lending to this class of borrower. Basically, however, major enterprises or well organized companies should find access to capital relatively easy.

Technology

While Lebanon has never served as a major manufacturing center using any level of technology, the country has historically employed relatively high levels of technology in its service sector, at least by regional standards. For example, Lebanon has a long and well established reputation as a center for medical services, including sophisticated procedures. Its universities were once centers of education for students from throughout the region.

The nation's technology base draws from several sources. It has access to the skills of overseas Lebanese, many of whom hold advanced degrees. Lebanon now possesses an established base of computer-based skills in hardware and software. Computers are assembled and repaired in Lebanon and software is being produced and sold. Mobile telephone systems have been established and are flourishing. Lebanon, especially the Beirut area, serves as home to significant numbers of trained financial analysts, economists, engineers, architects and lawyers.

In short, Lebanon does boast a relatively strong technological base. Deficiencies are most likely to be found in the middle to smaller scale industrial and manufacturing operations. Lebanon appears to have fallen behind in management and manufacturing technology due essentially to lack of sufficient investment.

Physical Infrastructure

As would be expected, Lebanon's physical infrastructure endured massive destruction during the civil war. Much has been restored. Electric power generation has been reinstated to previous levels so that electric power is generally available throughout the country on a 24 hour basis. Water facilities and distribution systems have largely been restored, at least in urban areas. Telephone service has been rebuilt to a considerable degree, although concerns over reliability have fueled the growth of the nation's thriving mobile telephone operations.

The reconstruction of transportation infrastructure and facilities is still under way. The port of Beirut is undergoing reconstruction and is a functioning port, but requires additional capital investment to bring it up to modern and competitive freight handling capabilities. The railroad system has not been restored to its pre-war state. The road system functions, but major road improvements have not yet been completed. Traffic congestion, especially in Beirut, is chronic and hence creates delays and losses in efficiency. The international airport at Beirut is in full operation, but is in the midst of a major modification project designed to increase its capacity and bring it to modern standards. Much of the reconstruction activity has been centered in Beirut, and hence infrastructure, especially good roads, remains inadequate in the areas outside Beirut.

Related in part to infrastructure considerations, Lebanon suffers from significant environmental problems such as water, soil and air pollution. There is growing concern among business leaders and the general population that environmental degradation poses a major threat to Lebanon's future well being. The imperative for national reconstruction of the country as first priority is accepted, but measures need to be taken soon to address the environmental problems.

Soft Infrastructure

A nation's "hard" economic infrastructure is defined as the physical systems and facilities -- bricks and mortar -- that support economic activities, as noted above. "Soft" infrastructure refers to the systems, institutions and regulatory and commercial environment that support productive economic activities. In this area, Lebanon presents a mixed situation.

The nation's commercial policy climate, as noted above, is very strong by regional standards. Its absence of foreign exchange controls and freedom to move capital are pluses. Problem areas include the lack of competition policy and IPR protection. In addition, the bureaucracy responsible for permits, regulations and customs administration does not function quickly or efficiently. Lebanon has plans for a series of free trade zones but has not yet put into place an effective free trade zone regime.

The types of soft infrastructure for which the private sector is responsible are in need of considerable upgrading. Briefly stated, the systems and structures which support industry cluster development are not competitive. Buyer/supplier relationships are often not carried out on a free market basis, but rather through monopolistic or oligopolistic relationships. Most industries are not sufficiently organized to sponsor joint efforts to explore new markets, access modern technology, provide advanced worker training, or even lobby collectively against policy constraints. In short, there is a need for private industry to assume greater responsibility for improving the environment for productive investment and economic activities.

VIII. PROPOSED ECONOMIC GROWTH STRATEGY/INITIATIVE

This project has focused substantively on Lebanon's economic and commercial policies. Its purposes have been to assess the nation's overall economic performance and policy framework, identify policy strengths and weaknesses, and articulate a medium-term initiative aimed at stimulating productive economic activities in Lebanon. This section presents the project team's proposed recommendation for an action-oriented initiative to catalyze growth in several industry "clusters" which are critical to Lebanon's future economic prospects.

A. Summary Diagnostic Assessment

The detailed findings of this exploratory phase have been presented in the previous sections of this report. They are based on: (1) a thorough review of literature analyzing Lebanon's economic structure, performance and policies; (2) interviews to elicit information and views of government leaders, business executives and business association staff, academics, private consultants and USAID and other donor officials; and (3) a scoring of Lebanon's commercial policies according to SRI's Commercial Policy Model and international database.

During the course of the investigation, it became increasingly clear that the substantive scope of subsequent phases of this initiative should be broadened somewhat from a solely policy-oriented focus to cover other issues affecting productive economic activities. This conclusion is based on the following considerations:

1. Lebanon's **macroeconomic strategy** is clearly known, and the level of sophistication of the country's economic management team is high. While there is a strong need to address the growing macroeconomic imbalances, as noted above, a major USAID-sponsored activity to deal with macroeconomic policy is not necessary. The appropriate approach would be to provide technical expertise to the government to explore the merits, costs and benefits of alternative options for achieving macroeconomic balance.

2. The majority of Lebanon's **commercial policies** - those forming the environment in which private sector firms operate - are essentially sound. In fact, they are among the most "market friendly" in the region. To be sure, a number of important commercial policy impediments remain in place, and some have been identified in this report. Nevertheless, any initiative directly solely toward improving commercial policies would not be productive. In view of Lebanon's unique circumstances, it would be more useful to address the issue of commercial policy constraints within the context of overall constraints facing productive enterprise.

3. A key constraint to new investments in productive activities can be summarized as **lack of confidence and direction**. This can be attributed in part to factors (e.g., regional political uncertainty, growing deficits and indebtedness) which are beyond the control of businesses, but also to a lack of consensus on a vision for the economy and hence insufficient investment in modernization in many industries.

Based on these considerations, it is proposed that the core set of activities under USAID's sponsored initiative be organized around the concept of "industry cluster" strategies. The conceptual framework of such strategies is presented below.

B. Industry Cluster Strategy Dynamics and Goals

The state-of-the-art economic development technique used in many advanced nations concentrates on developing, nurturing and retaining "industry clusters." An industry cluster consists of an "agglomeration" of private firms producing goods and services in associated or related fields. That is, the goods or services are similar in several respects:

- They require the same basic inputs, and comparative and competitive advantages.
- They build competitiveness based on supplier/buyer linkages and other inter-industry relationships.
- They operate on the basis of similar economic foundations.
- They grow, evolve, decline and are possibly renewed in an organic fashion.

Early examples of industry clusters include the coal industry in England, the steel industry in Western Pennsylvania, automobiles in Detroit, the shoe and garment industry in the Boston area, the precision engineering industry in Czechoslovakia, and the aircraft industry in Southern California. Examples of more modern industry clusters include the computer industry in Silicon Valley, the software industry in Utah, the tourism industry in Central Florida, and the medical services industry in the Philadelphia region.

Industry cluster initiatives provide a powerful framework for economic development strategies. They capture economic relationships within specific industry sub-sectors, and provide a set of tools to design and implement effective development strategies. The concept of industry clusters has become standard in economic development literature in the 1990s. Cluster strategies have been used primarily with a focus on specific regions rather than on entire nations. However, the geographic size of Lebanon is such that the cluster strategy framework can be applied appropriately.

Industry clusters are attracted to or grow within specific regions or nations. They rely on an active set of relationships among themselves to ensure individual and collective efficiency and competitiveness. They are linked and held together by buyer-supplier relationships (forward and backward linkages), competitor relationships, common customers, flows of factors (labor, technology, capital) between firms, and other factors such as the increasingly important role of service providers.

Buyer-supplier relationships consist of core companies that produce goods and services that are sold to final consumers (often “exported” both to other regions and other countries), and companies at earlier stages in the value-adding chain that supply inputs. Competitor/collaborator relationships include firms that produce the same or similar goods and services at a specific level in the value chain. Shared resource relationships exist when companies rely on the same sources of raw materials, technology, human resources and information. Ultimately, clusters represent “critical masses” of information, skills, relationships and infrastructure in a particular field. A critical mass of these competitiveness factors provides the foundation for cluster growth.

Industry cluster strategies are based on the belief that competitive economies consist of evolving, adapting sets of dynamic economic clusters. Industry clusters are made up of private companies that are linked to each other vertically, as buyers and suppliers, and horizontally, as competitors, partners, and sharers of specialized resources. Industry clusters benefit from and help generate specialized labor pools, suppliers and support services, creating economies of scale and ease of communication. In addition, the increased efficiencies from higher rates of innovation enable industry clusters, through “flexible specialization,” to respond effectively to shifting economic needs and realities.

The formation of industry clusters allows nations or regions within them to increase their industries’ productivity and competitiveness. In turn, industry clusters serve as engines of growth, raising standards of living and purchasing power in regional and local communities.

Every nation or region possesses a unique set of local conditions that underpin the ability of companies to compete and thrive. The ability of regional companies to grow and prosper depends on how effectively their region provides them with the **economic foundations** and resources they need. Depending on their condition, these economic foundations either support or deter industry cluster growth. Economic foundations consist of the "hard" and "soft" infrastructure that collectively support industry clusters, as well as the quality of life:

- **Hard economic infrastructure** includes the physical transportation, water and sanitation, communications and energy systems traditionally referred to as infrastructure.

- **Soft economic infrastructure** includes the institutions and systems that either enhance or detract from the quality of inputs -- an educated, well trained labor supply, access to modern financial instruments, access to adequate information and technology, etc. A critically important part of soft infrastructure consists of the policies, incentives and regulatory structures that promote (or constrain) productive investment and trade.

- Finally, a key ingredient or "glue" that makes the whole system fit together is **quality of life**, which is both a input to and output of successful industry cluster growth. An example is the way in which high quality of life stimulated the computer industry in Silicon Valley, and then the way in which a declining quality of life (rising cost of living, deteriorating educational systems, etc.) led to decline in Silicon Valley.

The quality of life of a nation can be measured by the region's ability to provide productive employment, goods and services (health, education, public safety, etc) to the population. Quality of life is clearly the ultimate objective of economic activities, but it also determines the extent to which a region can attract and retain businesses and their productive employees. Quality of life factors also have strong linkages with the conditions of specific economic foundations that support industry clusters.

The basic goals of industry cluster development approaches are as follows:

- ❑ Establish effective public/private coalitions organized around a reasonably defined, common set of challenges and opportunities.

- ❑ Identify through concrete examples key policy and institutional constraints to growth, and specify practical means to address these constraints.

- ❑ Define a consensus "vision" for industry cluster and economic growth. On the basis of that vision develop actionable strategies to stimulate the growth of viable industry clusters, which will in turn serve as key engines of overall economic growth.

It is recommended that on the basis of Lebanon's current economic conditions and prospects, a set of industry cluster development initiatives be supported by USAID. This is most likely to fit the unique needs of Lebanon as presented in this report. The initiatives should be based on the approach described below.

C. Lebanese Industry Clusters Proposed

Industry cluster strategies begin with the identification and definition of industry clusters holding strong prospects. This is typically based on detailed examination of output, employment and export concentration ratios, as well as on an assessment of comparative and competitive advantage. Simply stated, concentration ratios indicate whether the size of a given regional industry or set of activities in terms of output, employment or exports is greater or lesser than the average for the nation (or among nations).

This type of analysis is not possible for Lebanon in view of the lack of sufficiently detailed and accurate macroeconomic data. Accordingly, the project team based its analysis on available statistics and research, as well as on viewpoints expressed during substantive interviews. In addition, the team employed three criteria on which to base its proposed clusters:

- ❒ The activities should offer clear promise for growth, thus leading to expanded and new investments in productive Lebanese enterprises;

- ❒ The activities should be capable of creating considerable employment opportunities, tax revenues and foreign exchange earnings for Lebanon -- key economic objectives of the nation; and

- ❒ The clusters of activities should be sufficiently broad to permit the identification of broad arrays of structural and policy reform needs.

Based on this analysis and these criteria, the project team proposed that the three industry clusters -- (1) Light Industry and Agro-Industry, (2) Regional Business Services, and (3) Tourism, be used for the cluster strategy development process. Each of these clusters, as described below, offer an "export" orientation as well as direct benefits for the domestic economy.

Light Industry & Agro-Industry

This cluster is directed at Lebanese industry broadly defined to include light manufacturing and food processing. Lebanon has historically been a service economy, but it can be argued that its socio-economic conditions require a stronger industrial base, with its potential for employment, and a revived agricultural sector which can contribute to employment opportunities and better utilization of agricultural areas, reducing social pressures and rural-to-urban migration.

Lebanese industrial exports are varied, indicating an ability to identify specific niches in overseas markets. Historically, the three most important industries have been paper, clothing, food products and consumer-oriented chemical products. Lebanon needs to build on its apparent comparative advantages by aggressively seeking new export markets and at the same time bracing for the very likely decline of protection, leading to intense competition for those domestic industries not able to match global standards for price and quality. The selection process directing investment into specific products or sectors is best left to market forces rather than central planning organisms. In other words, it is best to leave the process to the natural entrepreneurial talents of the Lebanese business community.

Lebanon is not likely to prove competitive in world markets for mass produced manufactures, and it is not advisable to engage in manufacturing processes which are energy intensive or polluting. Lacking petroleum resources, Lebanon must import most of its energy and is thus at a comparative disadvantage to several of its neighbors. As a small, touristic country in which natural beauty is a major attraction, the country can ill afford aggravating its already existing environmental problems. Lebanese industry should seek product areas which involve flexible manufacturing and substantial value added in the form of technical input, design and quality. Selling these features successfully even in regional markets will place heavy emphasis on marketing skills.

For example, in the textile and apparel sector, textile mills and mass labor intensive production of garments should be avoided. Instead, emphasis should be placed on promoting the skill intensive functions of design and production of fashion items and their marketing and distribution. In electrical and electronic product area, again the labor intensive assembly in mass of components or goods should be avoided and efforts directed towards design and production of smaller volume, high value products, software development, marketing and distribution and after-sale services.

In the food and beverage areas, Lebanese processors need to develop access to quality raw materials at reasonable cost either through encouraging the cultivation of select fruit and vegetable items or more productive animal husbandry and fishing activities within Lebanon or, very importantly, assuring access to imported raw material, most likely from neighboring countries in the region. Final products could include soft drinks, processed meat, cereals, fruits and vegetables, sauces and food preparations, confections, dairy products, wines, and olive and other edible oils. Potential markets would include the local Lebanese market, especially supplying the tourist industry in a positive form of import substitution, and international markets with emphasis on ethnic foods as well as convenience or health oriented products. The potential for Lebanon in developing this sector is important as it will encourage employment generation in rural areas and more economic use of arable land.

In the area of metal fabrication, Lebanon is not well situated to be a major player. Areas where it may compete include jewelry and fashion accessories, metal decorative artifacts, profiles and fixtures for construction, and machinery of moderate technology and volume designed especially for regional markets. An example would be pumps or farm implements for the level of farming and industrial technology in place. The machinery after-sale market should also be explored, especially demand for replacement parts at reasonable prices.

In the textile, apparel and leather sector, in addition to growth potential for garments at the higher end of the market, there could also be fashion accessories made from leather, such as gloves, belts, handbags and wallets as well as decorative items of fabric such as ties, scarves, wall hangings and decorative carpets.

In the wood and paper sector, Lebanon's limited timber supplies suggest it depend on imported raw material. For paper products, this implies the conversion of imported pulp into finished papers, including quality packaging materials and those used in the printing and publishing industries. Furniture production should be confined to custom designed, high quality items for the higher end market.

Other miscellaneous industrial products which offer potential include personal and home care items (soaps, perfumes, toiletries, shampoos, cleansers), decorative ceramics and glassware, pharmaceuticals (licensed or generic) and fabricated building materials.

Achieving growth in manufactured goods exports requires not only the careful identification of appropriate market niches, but also measures to reduce local costs and inefficiencies in general, such as high import duties on inputs, high-cost transportation, inefficient port handing, inadequate labor conditions, regulatory obstacles or lack of adequate technology.

Regional Business Services

This cluster consists of a potentially wide array of productive activities, including regional banking and financial services, trading, communications, media/advertising/printing, and other business services. In theory, it could also be expanded at some stage to include regional education and health services, both previously major foreign exchange earning activities in Lebanon. This cluster is intended to test the hypothesis that Lebanon can restore its role as a regional business center. These activities face the prospect of significant growth in the Middle/Near East region, and offer high value employment and income producing opportunities.

Regaining Lebanon's previous preeminence in regional entrepôt activities will not be easy. Competitive centers have arisen in the area, including Cairo, Amman, Manama, Dubai and Nicosia. Also, the revolution in telecommunications and globalization of information services in recent years has eroded the need for regional centers. Instant access to financial giants in London, New York, Tokyo and Singapore can be obtained from almost any point on the globe. This is less true for the physical movement of goods. Lebanon can serve again as a major trading center but it will require infrastructure beyond the pre-civil war level. At present, the movement of goods is concentrated in containers carried on increasingly larger vessels. Ports which can handle very large volumes efficiently, at competitive prices and, very importantly, with minimal ship turn-around times will dominate the market. The use of ports is obviously conditioned on the market served, i.e., demand for goods in the area served by the port. Beirut's attractiveness as a port will hence depend as well on the ability of moving goods efficiently by road to markets well beyond the national borders.

With growth in cargo handling can be expected parallel growth in related services such as trade insurance and financing, warehousing, distribution and marketing. Absent adequate physical infrastructure and a facilitating legal and regulatory environment, the needed market development and potential growth in these services will be severely handicapped.

Other areas of potential service cluster growth include advertising, finance, insurance, printing and publishing. To succeed in these areas, Lebanon needs to differentiate its product from that available in world centers, whether by language, cultural affinity or in-depth knowledge of the region's requirements. Potential clients have to feel more comfortable dealing in Lebanon than in Europe, for example, and confident as well that the level of service they receive is world class. Again, the legal and regulatory framework has to be right and the technical level of service competitive with world best practices.

Tourism

Lebanon was once a leading tourism destination in the region, offering an impressive array of attractions for respective market segments -- pleasant climate and natural attractions, entertainment and culture, high quality hotels and restaurants, shopping, and a rich historical heritage. Many of these attractions were destroyed or deteriorated during the war, but could be restored. Tourism is a major global growth industry, and offers considerable employment opportunities for unskilled and semi-skilled labor. Tourism can also serve as a platform for the development of other industries through backward linkages and associated international services.

Restoration of tourism as a major factor in Lebanon's economy requires a concerted and broad-based effort. Careful analysis needs to be made of which market segments are most suitable for Lebanon, and which attractions should be offered. Will Lebanon depend solely on business travel, or should it seek those interested in antiquities or different cultures and cultural events? What can be done to improve the supporting infrastructure and facilities? What improvements are needed in visa and customs formalities, tour facilities, production of goods attractive to tourists, restaurants, foreign language capabilities, etc? Answers to these questions must be factored together to develop a framework in which effective development can take place.

D. Industry Cluster Working Group Participants

In view of the inherent politicization of almost all issues in Lebanon, great care must be taken to select the right participants of industry cluster working groups. It is proposed that the groups be limited to no more than 10 participants in order to ensure appropriate dynamics and efficiency. The participants must acknowledge that the working groups are to operate on a consensus basis and are not intended to be "complaint sessions." In addition, while difficult to achieve in practice, members will be instructed that they are participating as knowledgeable individuals rather than as representatives of any respective organization (public or private) of which they are part.

The participants will be selected on the basis of the following criteria:

- They have a strong knowledge and understanding of their respective industry cluster and the conditions it faces.

- They demonstrate commitment to overall Lebanese economic growth (beyond that of their agency, association or firm) and commitment to means to achieve that end, including policy reform.

- They display a willingness to collaborate with their fellow participants on an objective basis.

- They demonstrate an ability to communicate effectively with relevant stakeholders, public and private, regarding initiatives, roles and responsibilities derived from the industry cluster action plans.

E. Proposed Cluster Group Activities and Tasks

Industry cluster strategies are established and implemented to the following process. The core activity is the establishment of industry cluster "working groups" consisting of individuals drawn from both the public and private sectors. The basic objective of the working groups is to craft and implement focused industry cluster strategies. This will be achieved through the following progressive set of activities:

1. First, a set of industry clusters is specified (as presented above).

2. Second, a set of working group participants is identified according to a set of criteria, as described above.

3. Third, the working groups meet to proceed through the following agenda of tasks for each industry cluster in a logical, building-block manner. The proposed project phases, objectives and tasks are presented below:

Phase I: Initial Orientation and Start-Up Activities

Objective: Introduce stakeholders to the goals, process and desired outcomes of the process, and establish a strong foundation for project implementation.

Tasks:

1. Receive a briefing on the industry cluster technique and process.

2. Review the working group's operating rules, goals, roles and responsibilities.

3. Map the specific definition of the industry cluster -- the product/service categories included.

Phase II: Assessment of Regional Industry Clusters and Economic Infrastructure

Objective: Develop an in-depth understanding of the industry cluster identified, determine their competitiveness and future growth potential, evaluate the ability of the region's economic infrastructure to support the expansion of the cluster over time, and define a consensus vision for industry cluster growth.

Tasks:

1. Assemble and analyze data on the industry cluster, focusing on growth patterns, buyer/supplier relationships, concentrations of employment, productivity, value-added, etc.

2. Prepare an objective review of the state of relevant economic foundations. The economic foundations to be examined include the quality and quantity of the region's **labor resources**, availability of and access to **capital and credit**, **natural resource endowments** and constraints, the sophistication of **technology** applications, the region's **physical infrastructure**, **institutional capabilities** and the **policy and regulatory environment**.

3. Identify the respective industry cluster's **"SWOTs" -- Strengths, Weaknesses, Opportunities and Threats** -- as well as high potential markets, in the context of the cluster's competitiveness drivers.

4. Develop a consensus view or vision for the industry cluster in as specific terms as possible.

Phase III: Preparation of Cluster Development Action Plans

Objective: Craft an overall strategic plan for cluster growth, design detailed initiatives as part of the strategic plan, assign roles and responsibilities, and identify appropriate measures for monitoring implementation and follow-up activities.

Tasks:

1. Determine the general means and requirements needed to achieve the cluster vision by enhancing the competitiveness of the entire "value chain" of the industry cluster (the collective

firms, support institutions and processes involved in the entire value chain of the industry – input suppliers, producers, marketers, service providers, packagers, etc.). On the basis of this information, prepare an overall cluster development strategy.

2. Specify a select set of achievable, industry specific initiatives. These will include both policy and administrative reform actions that fall under governmental responsibility, and investment and other actions that fall under the responsibility of private businesses, operating individually and collectively.

3. Prepare detailed implementation action plans and identify specific roles and responsibilities.

4. Determine the institutional mechanisms required to implement the cluster action plans, monitor progress, and ensure completion of tasks assigned.

5. Integrate the findings generated by cluster leadership groups and provide a synthesis analysis, strategy and implementation action plan.

The number of meetings required to work through this agenda/process will vary, depending on the aggressiveness and dynamics of the individual working groups. The working groups will be provided assistance by expatriate industry specialists and cluster process facilitators as well as by local experts. At the end of the process, a major one day conference will be held to disseminate information on the process, the findings and recommendations of the three working groups, and responsibilities of the private and public sector stakeholders.

Project Timing

In view of the urgent need for Lebanon to achieve accelerated economic growth as quickly as possible, it is proposed that this project be carried out according to an ambitious time schedule. While some flexibility will required to complete initial start-up formalities, the following time frame is proposed.

Project Phase	**Duration of Activity**	**Completion of Tasks**
Phase II	Months 2-3	End of Month 3
Phase III	Months 3-4	End of Month 4

APPENDIX 1

INSTITUTIONAL STAKEHOLDERS IN LEBANON'S ECONOMIC DEVELOPMENT

The project team was asked to identify relevant stakeholders and potential partners in prospective economic development initiatives in Lebanon. The stakeholder groups described below are not inclusive, but include a range of public and private sector institutions which have a stake in a degree of responsibility for the economic development of Lebanon.

Government Organizations

The ministries which are most directly focused on the nation's economy and its needs for growth include Finance, Industry, Economy and Trade, and Agriculture. Other important government institutions include the central bank, *Banque du Liban*, and the Investment Development Authority of Lebanon

The **Ministry of Finance,** as keeper of the public purse, is vitally interested in the administration and collection of taxes and other central government revenues as well as overseeing the expenditures of public funds. The Finance Ministry plays a critical role in the preparation of annual budgets and in the management of public debt. It is a key player in macroeconomic policy formulation and the very important effort to reform and strengthen the government's fiscal administration.

The **Ministry of Industry** is vitally concerned with Lebanon's industrial development and its ability to grow and thus expand employment and export earnings. Measures which affect the competitiveness and health of Lebanese manufacturing are its direct concern. These include the regulatory and legal environment in which industry operates, the availability and cost of inputs such as labor, transportation, finance or utilities, and the impact of fiscal and social policies on the ability of industry to operate. The Ministry is responsible as well for the development of industrial standards and the promotion of industrial modernization.

The **Ministry of Economy and Trade** is also intimately concerned with economic growth and development in Lebanon, but with a purview that includes services as well as goods and a greater focus on international trade. The Ministry plays a lead role in managing Lebanon's foreign trade relations with a prime interest in expanding international market access for Lebanon's goods and services, taking into account Lebanese vulnerabilities to foreign competition. This Ministry is also involved in assuring that the legal and regulatory environment is truly conducive to the promotion of business and that existing constraints to doing business in the country are reduced or eliminated.

The **Ministry of Agriculture** is responsible for assisting Lebanon's agricultural sector, which employs directly or indirectly about 20 percent of the population but generates only 7 percent of the nation's GDP. A key goal of the Ministry is to rebuild the agricultural sector from the devastation of the war years and, more importantly, to modernize and redirect agricultural production into those areas and crops which represent greater value for Lebanon. The issues of land tenure, technology, crop selection, water rights and protection of the environment all enter into its sphere of responsibility. A more productive agricultural base will provide greater rural income, offer a larger share of the domestic market to local growers, and supply the food processing industry with added raw materials for both domestic and export markets.

Lebanon's Central Bank, ***Banque du Liban***, plays a critical role in the nation's macroeconomic policy formation, since it holds responsibility for implementing monetary policy, supervising the commercial banking sector and managing Lebanon's foreign exchange reserves. The Bank's ability to set reserve requirements for commercial banks directly affects the country's financial liquidity and indirectly the formal interest rate structure. It's management of foreign exchange reserves affects the exchange rate of the Lebanese pound relative to key foreign currencies and, in combination with its effect on interest rates, Lebanon's ability to attract the foreign capital necessary to finance public debt and cover the trade deficit.

The **Investment Development Authority of Lebanon** (IDAL) is a government entity which reports to the Council of Ministers and is charged with promoting foreign direct investment inflows into Lebanon. It is active in promoting the image of Lebanon abroad as an attractive place in which to do business. A major thrust in its investment promotion program has been the development of free trade zones. IDAL activities recently have been directed to attracting investment in infrastructure projects, especially roads, through projects involving "Build, Operate and Transfer" (BOT) and "Design, Build, Operate and Transfer" (DBOT) in which foreign capital will finance the projects in return for repayment over a period of years after which the asset transfers to public ownership.

Private Sector Organizations

A number of private sector groups hold a strong interest in the business environment, and economic and commercial policy.

The **Association of Lebanese Industrialists** represents the country's manufacturing sector and is chiefly concerned with those policies and conditions which affect them. It works both as a business association seeking through studies and other assistance to improve Lebanon's industrial capacity and as a lobbying group working to assure favorable regulatory and legal conditions for industry, especially in areas like taxes, tariff rates and international trade agreements. Membership is voluntary but limited to companies headquartered in Lebanon and to whose membership has been recommended by two other members.

The **Chamber of Commerce, Industry and Agriculture of Mount Lebanon** is the largest of the four regional chambers of commerce in the country. The Chamber reflects the views and interests of the major players in the business community. The Chamber has acted as host for policy conferences to review economic problems, and serves as a focal point for links with overseas business organizations. It is also actively involved in efforts to attract investment into Lebanon.

The **Assembly of Lebanese Company Directors and Managers** (RDCL) was formed in 1986 with the goal of utilizing the experience and strength of Lebanon's business leaders in the development of coherent and rational economic policy proposals appropriate to Lebanon's requirements for modernization and growth. These proposals are then presented to the appropriate government authorities to be translated into action. Its General Assembly reviews and debates policy issues, which are then further researched and developed by "brainstorming groups." The resulting studies are subsequently disseminated and promoted by a Coordination Committee. Position papers published have touched on income tax, salary issues, the role of employers in developing the economy, and the Reconstruction Program. A recent "white paper" provided a detailed analysis of the Lebanese economy.

The **Lebanese Bankers Association** acts as a steering committee and management resource for Lebanon's commercial banks. It has strongly supported the modernization and liberalization of the banking sector. It also publishes financial statistics and offers training courses in its facilities. It is widely credited with being a strong force behind the impressive modernization of commercial banking in Lebanon over the past five years.

The **General Confederation of Lebanese Employees** is the umbrella organization for Lebanon's labor unions and employee associations. Its interests include labor conditions, social expenditures, treatment of foreign workers, wage rates, and the government's economic policies as they affect the income levels and living conditions of Lebanon's labor force.

The **Center for Lebanese Policy Studies** is a private "think tank" devoted to research and the development of position papers on social and economic issues affecting Lebanon. It has been well regarded for the quality of its research but views presented on specific economic or social policies are sometimes considered controversial.

Several of the major universities through their economic and other departments influence the conduct of social and economic policy as well. These include:

Lebanese University, a state-supported institution, has the largest enrollment of all universities in Lebanon, with over half of Lebanon's university students enrolled. Only 3 percent of its students are reported to be studying business or economics.

The **Arab University of Beirut** has only half the enrollment of the Lebanese University but twice as many economics and business majors. These two institutions appear to have 70 percent of all university enrollees in Lebanon.

Three important private universities with enrollments of approximately 5,000 students each are the **American University of Beirut**, **Saint Joseph University** and the **Lebanese American University** (formerly Beirut University College). At SJU and LAU, between 30 to 40 percent of the students are enrolled in business administration or economics majors. Figures for the 1994-1995 academic years show no breakout of AUB students in the economics or business administration disciplines.

The nation's universities have traditionally played an important role in support of Lebanon's position as a regional center, with as many as 40 percent of the student body comprised of non-Lebanese students. This figure has dropped to a current estimate of 23 percent. Anecdotal evidence suggests that many university graduates emigrate owing to Lebanon's lack of adequate employment opportunities. The universities thus have a strong stake in Lebanon's ability to expand its economy and achieve social, economic and political stability and progress.